IN THE

Supreme Court of the United States,

OCTOBER TERM, 1927.

F. H. MASON,

Petitioner,

against

C. F. ROUTZAHN, Collector of Internal Revenue for the Eighteenth District of Ohio

Respondent.

REPLY BRIEF OF PETITIONER

The first point in our main brief was that the Circuit Court of Appeals erred in holding that the earnings for 1917, although shown to have been made after the dividend dates, may be treated as the source of payment for the purposes of fixing the tax rates under Section 31-b. The government does not contest the correctness of this position, stating that it feels "unable to urge this court to affirm that decision" (brief for the Respondent, p. 8). It would seem, therefore, that it is unnecessary to say anything more on this point.

We do, however, wish to call attention to the fact that the brief for the government suggests that in *Edwards* v. *Douglas* this Court considered the suggestion that where a corporation cannot accurately ascertain

the amount of its earnings between the first of the year and the date of the dividend distribution it is proper to determine them by pro-rating to that period the earnings for the entire year. We do not concur in this suggestion. The question was neither raised, argued nor reserved in *Edwards* v. *Douglas;* neither is it material in the present case, where it is affirmatively shown that there were no 1917 earnings up to the dividend dates.

Therefore, the only question of interpretation which remains is whether in determining the source of a dividend the earnings existing at the time of the declaration of the dividend are to be looked to or whether the earnings made after the declaration of the dividend and before its payment are to be included as a part of the fund distributed.

The government in its brief has not even endeavored to answer the main propositions upon which we rely. These propositions are:

First. That the statute does not expressly specify as of what date the "most recently accumulated undivided profits or surplus" are to be determined. This proposition is stated in our main brief at page 19 and at page 5 of the brief submitted by Charles E. Hughes, Esq., et al. as amici curiae.

Second. The proposition that the failure of the statute to specify as of what date the most recently accumulated undivided profits or surplus are to be determined is conclusive that it intended to leave the selection of that date just where it found it, and that the selection should be made in accordance with the rules of corporate and criminal law and sound corporate practice. This proposition is stated at page 26 of our

main brief and at page 7 of the brief of the amici curiae.

The argument of the government seems to boil down to this: That the requirement that the earnings up to the date of the payment of the dividend shall be included in determining the source of the dividend, is to be read into the statute, because of the use of the words "distribution made" in conjunction with the words "most recently accumulated undivided profits or surplus." The government says that the words "distribution made" mean "dividend paid," and that when Congress said that a "distribution shall be deemed to have been made from the most recently accumulated undivided profits or surplus," it referred to the earnings existing when the dividend was paid.

It should be noted that this is a very narrow and technical argument. It seeks by implication to substitute for the fund which is legally, practically and customarily recognized as the source of a dividend a totally different fund—one which is not in existence when the dividend is declared. It is proper, therefore, to consider whether there is anything in the situation to indicate that Congress intended so narrow a meaning and a purpose so abnormal. If it should appear that to give those words that narrow meaning throughout the Section would defeat some of the obvious and avowed purposes of Congress and that in certain parts of the Section they must, in order to avoid absurdity, be interpreted otherwise, then there is no reason why when used to define the source of a dividend they should be given that unnatural and narrow meaning.

In enacting Section 31-b Congress had in mind four main purposes with respect to which the question of

what constitutes a dividend distribution was material.

(1) To define the class of dividends embraced within the purview of the statute.

(2) To designate what earnings are deemed to have been distributed by a dividend.

(3) To permit the distribution exempt from tax of any earnings accrued before March 1, 1913, after the distribution of all earnings subsequently accumulated.

(4) To exclude from the provisions of Section 31-b a distribution made prior to August 6, 1917, out of earnings accrued before March 1, 1913.

Can these purposes be given effect by interpreting the words "distribution made" throughout this section as meaning "dividend paid"? It will facilitate the answering of this question to consider the effectuation of these purposes in the reverse order to that in which they have been stated.

(1) If we give the words "distribution made" the meaning "dividend paid," in the proviso at the end of Section 31-b the purpose of Congress in adding that proviso would be defeated. The purpose of this proviso was, as stated in our main brief, to keep faith with the stockholders of a corporation, the directors of which in reliance upon the existing law and before they had notice of any proposed change, had expressly declared a dividend to be payable out of a surplus existing on March 1, 1913. (See brief of Petitioner, pages 24-25; brief filed by Charles E. Hughes, Esq., et als., page 14; and brief filed by James E. MacCloskey, Jr.)

The government practically admits that for the effectuation of this purpose the words "distribution made" can not be given the meaning dividend paid. In

its brief it does not attempt to claim that to exclude from the proviso a dividend declared before August 6 and paid afterwards would accord with the intention of Congress. All that it can suggest is that a corporation which had before August 6 declared a dividend expressly payable out of earnings accrued before March 1, 1913, and had made that dividend payable at a date *after* August 6, 1917, might protect its stockholders from the high 1917 rates by rescinding the dividend. But if the statute is interpreted so as to compel a revocation of the dividend the purpose of Congress is completely defeated. What Congress intended was that such a dividend should be protected and preserved by the proviso; not nullified thereby. To say that the dividend can be revoked by a corporation would not effect this congressional intent but on the contrary destroy it. We pass without comment but we do not acquiesce in the suggestion that a dividend legally declared could be revoked under such circumstances over objection of the stockholders.

(2) If the word "distribution" as used in the clause permitting the distribution of earnings accrued before March 1, 1913, after the distribution of all earnings subsequently accumulated be limited to the meaning "dividend paid" the provision becomes unworkable. The condition precedent to a distribution of tax free profits accrued prior to March 1, 1913, is that it occur after the distribution of profits accrued *since* March 1, 1913, has been made. If the declaration of such profits accrued after March 1, 1913, only becomes effective on the date of the payment and so attaches to and distributes the profits accrued intermediate to the declaration and payment date, then any attempted distribution of such profits accrued *since* March 1, 1913,

is ineffective to pay out all such earnings in a case where the corporation is a going concern and makes earnings after the declaration date. If the directors acting in good faith seek to declare out all of the subsequent profits shown by the corporate books at the date of the declaration and if the dividend attaches to profits subsequent thereto and up to the payment date, and operates to pay them out, the "declaration" would leave in the coffers of the corporation a residuum of earnings and profits accrued since March 1, 1913, undistributed. Therefore the condition precedent to a distribution of March 1, 1913, profits would not be complied with. The directors of the corporation, therefore, although endeavoring by all means within their power to denude the corporation of its profits accrued since March 1, 1913, so as to comply with the requirements of the statute as a prerequisite to the declaration of the March 1, 1913, earnings, would be helpless because by the terms of the statute their declaration would be forced to embrace profits accrued subsequent to the declaration date, thus rendering the declaration defective by the amount of such subsequent profits. Nor could this condition be cured by the directors making another distribution of this residuum of profits because that second distribution would fall likewise within the terms of statute and be subject to the same infirmity. So the directors of a going corporation making profits would always be confronted with an irreducible residuum accrued after March 1, 1913, that they were precluded from paying out and so could never comply with the statute permitting a distribution of the March 1, 1913, profits.

(3) If the words "distribution made" be given the meaning, *dividend paid*, in the clause which says what earnings are deemed to have been distributed by a

dividend, there is substituted for the accepted rule laid down by the principles of corporation and criminal law an arbitrary and artificial rule whereby the source of a dividend is deemed to be a fund which did not exist when the dividend was declared. There is nothing in the words which Congress used to indicate that it intended to create that unnatural and abnormal situation.

We think that what we have said amounts to a demonstration that the Government's argument that this abnormal and unnatural rule must be read into the statute, simply because Congress has used the words "distribution made," can not be maintained. These words can not be given the meaning "dividend paid" in at least two of the places in which they have been used. Therefore there is *no necessity* for giving the words that meaning, when Congress used them in designating what earnings are deemed to have been distributed by a dividend. There is *no propriety* in giving them that meaning, because to do so is to produce an abnormal and illogical result.

(4) The Solicitor General finally makes the claim that our argument, if carried to its logical conclusion, would lead to the result that a dividend declared in 1916, but paid in 1917, is not covered by the provisions of Sec. 31 (b), and is therefore taxable at the high 1917 rates no matter what its source.

The Government says that the purpose of Congress in defining the class of dividends to be embraced within the purview of Section 31 (b) will be defeated unless the words "distribution made," as used in the first sentence, be given the meaning "dividend paid." It suggests that to exclude from the provisions of Section 31 (b) a dividend declared in 1916 but paid in 1917,

would be so arbitrary and unreasonable as to clearly be contrary to the congressional intent. We assert that such a dividend should be included as subject to the provisions of Section 31 (b). But is this in any way inconsistent with our position that in the clause which designates what earnings are deemed to have been distributed by a dividend the words "distribution made" should not be given the meaning of "dividend paid"?

We are at a loss to understand why any of the manifest intentions of Congress in various parts of this section should be defeated by giving to particular words or phrases used throughout this section a limited meaning, where such words or phrases are sufficiently broad or flexible to permit the accomplishment of all of these purposes. The phrase "distribution made" is sufficiently general and flexible to permit the effectuation of each and all of the purposes of Congress.

The argument of the taxpayer is that in interpreting Section 31 (b) the courts should do something more than consult the dictionary and a grammar and should endeavor to give a logical and reasonable effect to the words used by Congress in the light of its obvious and admitted purposes.

There is no necessity to pervert the meaning of the words "distribution made." All that is required is that they be given their true significance.

In the nature of things a dividend distribution is neither exclusively the declaration of a dividend nor the payment of a dividend. A dividend distribution has two distinct phases. First, it is the deliberation of the Board of Directors and the resolution whereby a part of the assets of the corporation are appropriated and set aside as the property of the stockholders. This is the substantial part of the procedure, but it is not the

entire transaction. There remains the actual payment to the stockholders, which in practice takes place as a separate act at a later date. A reference to a dividend distribution connotes the entire transaction, beginning with the meeting of the Board of Directors and ending with the receipt of the dividend checks by the stockholders. Nevertheless, when used in certain contexts and with certain purposes in mind, the phrase may properly be deemed to refer to one part or the other of the transaction.

In the various places in which the phrase "distribution made" is used in Section 31 (b), Congress had four separate purposes in mind and naturally enough was regarding the distribution from the standpoint of the accomplishment of each separate purpose. When in the proviso its purpose was to protect the stockholders of corporations which, in declaring dividends out of earnings accrued prior to March 1st, were relying upon the then existing law, and had received no notice of the proposed change in the law, it must have had in mind the action of the Board of Directors in declaring the dividend, because for the accomplishment of its purpose that constituted the significant part of the procedure incidental to a dividend distribution. Therefore, it is only reasonable to assume that in referring to a dividend distribution made prior to August 6, 1917, Congress meant a dividend which had been *declared* before that date.

Likewise, when permitting the distribution of the profits accrued before March 1, 1913, Congress did not intend to attach a condition precedent that would nullify this privilege, yet to make the distributions effective against the earnings up *to the date of pay-*

ment of the dividend would destroy this privilege, and render those provisions unworkable.

Similarly, when in laying down a conclusive presumption whereby earnings should be deemed to have been distributed in the inverse order of their accumulation and thereby eliminating the discretion of the Board of Directors in specifying what earnings were distributed, Congress must have had in mind the part of the transaction consisting of the action of the Board of Directors. One reason is that that is the time as of which the Board of Directors would have exercised that discretion and another and more important reason is that that is the time as of which, according to established rules of law and accounting, the source of the dividend is fixed. Therefore, as there used, the words "distribution made" mean "dividend declared."

When the purpose of Congress was to provide what dividends should be governed by the provisions of Section 31 (b), it naturally had in mind not the time when the Board of Directors acted but the time when the dividend was physically paid, because it was the physical payment of the dividend which was material for the purposes of the application of this section. Of course, Congress was dealing with payments that were made in the specified tax years, and this is shown by the express provision making the distribution income in the year in which received by the stockholder. The section fixed the rates for the taxation of dividends received by stockholders and its application should depend not upon the time that the dividend was declared but upon the time when it was paid. This is made clear by the words which Congress expressly used. It said, "any distribution made to the shareholders of a corporation in the year 1917." This is a clear indi-

cation of what it had in mind and is in clear contradistinction to the thought which prevailed in the other parts of the Section when the significant factor was the action of the Board of Directors.

The difficulties which beset the Government's argument arise entirely from its attempt to place upon the broad and general phrase "distribution made" a narrow and inflexible meaning. The Solicitor takes the position that there are only two constructions that can be given to this phrase: it either means "dividend paid" or "dividend declared." Starting from either of these alternatives argument ends in irreconcilable inconsistency. The dilemmas that the Solicitor raises are entirely of his own making and do not inhere either in the statute or in its phraseology.

There are two or three collateral and minor matters mentioned in the Government's brief to which it is necessary to refer:

(1) The Solicitor's reference to Section 58 of the New York stock corporation law is not happy. A reading of this section discloses that the words "distributions made" are used in it in no narrow or limited meaning but embrace the declaration as well as the physical payment of the dividend. The statute quoted helps rather than hurts the taxpayer's position.

(2) The argument of the Government, made at p. 21 of its brief, that the purpose of the statute will be best served by the interpretation which it suggests need not be discussed further than to say that it begs the entire question. It is suggested that there is no reason why one stockholder who receives a dividend on June 30, 1917, should pay the law of 1917 rate if the dividend was declared on June 30th, but the law of 1916 rate

if it was declared on January 2nd. In truth there is every reason in the world for the distinction. The purpose of Congress was that dividends should be taxed at the rate applicable to the year in which the earnings distributed by them were accumulated by the corporation. Every one knows offhand and without analysis that a dividend declared on January 2, 1917, must constitute a distribution of earnings accumulated in 1916 or prior years.

(3) At page 23 the Government's brief says: "From the beginning the Treasury Department construed the statute to mean that the distribution is made when the dividend is paid." This statement does not seem to be supported by the following reference to the various actions of the Treasury Department and its Solicitor under this section.

The reference is to Regulation 33 (Revised), promulgated on January 3, 1918. It is true that this section places the date of the dividend payment as the time of the determination of the current earnings to which it applies; yet in the same paragraph it lays down a different rule for the proviso. It is here stated (italics ours):

> "The provisions of section 31, subdivision (b) do not apply to distributions made prior to August 6, 1917, out of earnings or profits accrued prior to March 1, 1913; that is to say, that such distributions will not be deemed to have been made out of the most recently accumulated surplus or profits, if *at the time of distribution*, before August 6, 1917, they were *specifically declared* to be out of accumulations prior to March 1, 1913."

This position that a distribution becomes effective at the date of the declaration was in exact accord with

the opinion expressed by Commissioner Gates on November 30, 1915. He wrote to the Corporation Trust Company a letter (see the company's Income Tax Service, 1916, at par 66), in which he said:

> "that a surplus representing the net earnings of a corporation, regardless of the period during which earned, is subject to the income tax as dividends *when distributed, whether by declaration of dividends or otherwise*, if the distribution was authorized on or after March 1, 1913." (Italics ours.)

The question was presented to the Board of Tax Appeals in the case of A. H. Stange, and in March, 1925, that Board decided the Stange case, holding that the words "distribution made" in Section 31 (b) meant the declaration of a dividend, as distinguished from its payment. On July 27, 1925, the Commissioner published his acquiescence in this decision, thus establishing this construction as one recognized by the Bureau. This recognition was reported early in the year 1926, at the time of the publication of Cumulative Bulletin CB IV—2, p. 6. This acquiescence was not withdrawn until eight months thereafter, on March 22, 1926, or approximately one year after the decision of the Stange case. Internal Revenue Bulletin V-12, p. 1.

Furthermore, on the precise point involved in this case, namely, whether the date of declaration or the date of payment should govern in determining the source of a dividend, there has been no continuity of practice. It is true that for a number of years the Regulations provided that the date of payment should govern. Nevertheless, in this case and in other cases, it was contended by the Treasury Department that neither the date of payment nor the date of declaration should govern, but that all of the earnings during the

entire year should be deemed the source of the dividend.

(See *U. S.* v. *Phillips*, pending before the United States Circuit Court of Appeals for the Third Circuit. See also the Kirby case in the Court of Claims, now on writ of certiorari to this Court.)

Immediately after the decision of the Circuit Court of Appeals in the present case, a ruling was handed down by the Treasury Department reversing its former ruling and declaring that the rule thereafter would be that the earnings of the entire year would be regarded as the source of the dividend.

In view of this record it is difficult to follow the Government's argument on any uniform practice of the Treasury Department or its representatives. Whatever this Court may decide, it must, *ex necessite*, be inconsistent with the position which the Treasury Department has taken at some time or other.

Respectfully submitted,

S. M. JETT,

HORACE ANDREWS,

Counsel for Petitioner.

CHARLES E. HUGHES,

HARRISON TWEED,

Of Counsel.

J. D. Mason,

Petitioner,

vs.

C. F. Bouvaird, Collector of Internal Revenue,

Respondent.

BRIEF FOR PLAINTIFF IN ERROR.

S. M. Jett,

Horace Andrews,

Attorneys for Petitioner.

No. 770.

In the Supreme Court of the United States

F. H. Mason,

Petitioner,

vs.

C. F. Routzahn, Collector of Internal Revenue,

Respondent.

BRIEF FOR PLAINTIFF IN ERROR.

S. M. Jett,

Horace Andrews,

Attorneys for Petitioner.

INDEX.

I. Case on Writ of Certiorari 1

II. Case Involves Construction of Section 31-b of Revenue Act of 1917 1

III. Statement of the Case 2

IV. Decision of Circuit Court of Appeals Erroneous 4

Argument:

Point I. As Used in Section 31-b of the 1917 Act, the "Most Recently Accumulated Undivided Profits or Surplus" Meant Those Which Had Been Earned by the Corporation Before and Up to the Dividend Distribution, and Did Not Include Those Coming Into Existence During the Same Year But After the Distribution 8

Point II. For the Purpose of Determining from What Year's Profits or Surplus a Dividend Distribution is Deemed to Have Been Made, the Dividend Declaration Constitutes the "Distribution" Within the Intent and Meaning of Section 31-b 19

Conclusion 31

Cases Cited.

Appeal of Maurice J. Curran, 5 B. T. A. 180, C. C. H. 1926 B. T. A. Service, Vol. 3, p. 3399 .....26, 31

Appeal of Mary A. Fitzgerald, 5 B. T. A. 178, C. C. H. 1926 B. T. A. Service, Vol. 3, p. 3389 .....26, 31

Appeal of Harmon W. Hendricks, 4 B. T. A. 1257; C. C. H. 1926 B. T. A. Service, Vol. 3, p. 3259 ...26, 31

Appeal of A. H. Stange, 1 B. T. A. 810 .....26, 28, 31

Bowers vs. Post, 209 Fed. 660 21

Edwards vs. Douglas, 269 U. S. 204, 208, 216 ..... 4, 7, 10, 12, 13, 14

Eidman vs. Martinez, 184 U. S. 578, 583 12

Fletcher, Cyc. of Corporations, Vol. 6, Sec. 3853; L. R. A. 1917 (b) 728 and 736 21

Hopper vs. Sage, 112 N. Y. 553 21

Laurie vs. Trust Co., 272 N. Y. 137 21

Mason vs. Routzahn, 8 Fed. (2nd) 56 1

Montgomery on Income Tax Procedure (1918 Edition) page 153 25

Partington vs. Attorney General, 4 H. L. 100, 122 12

Phillips vs. U. S., 12 Fed. (2nd) 598 26

Plant vs. Walsh, 280 Fed. 722 26

Routzahn vs. Mason, 13 Fed. (2nd) 702 1

Smietanka vs. Bank, 257 U. S. 602, 605, 606 12

U. S. Trust Co. vs. Barker, 33 N. Y. Supp. 388 21

U. S. vs. Guinzburg, 278 Fed. 363; (C. C. A., 2nd Circuit) 21, 26

U. S. vs. Merriam, 263 U. S. 179 12

Wheeler vs. Northwestern Sleigh Co., 39 Fed. 347 21

Statutes.

Revenue Act of 1917, Section 31-b 1

Congressional Record, Vol. 55, part 7, pp. 6869-70, 6877-86 17

Treasury Regulation No. 33 18

Revenue Act of 1917, Section 1200 24

Revenue Act of 1917, Sections 1 and 2 24

SUMMARY OF ARGUMENT.

Point I. As used in Section 31 (b) of the 1917 Act, "most recently accumulated undivided profits or surplus" meant those which had been earned by the corporation before and up to the dividend distribution, and did not include those coming into existence during the same year but after the distribution. (p. 8)

Point II. For the purpose of determining from what year's profits or surplus a dividend distribution is deemed to have been made, the dividend declaration constitutes the "distribution" within the intent and meaning of Section 31 (b). (p. 19)

No. 770.

In the Supreme Court of the United States

F. H. Mason,
Petitioner,

vs.

C. F. Routzahn, Collector of
Internal Revenue,
Respondent.

BRIEF FOR PLAINTIFF IN ERROR.

I.

This case comes before this Court on a writ of certiorari to review the decision of the Circuit Court of Appeals for the Sixth Circuit, entered June 30, 1926, reversing the judgment of the District Court. The decision of the District Court is reported in *Mason v. Routzahn*, 8 Fed. (2nd) 56, that of the Circuit Court of Appeals in *Routzahn v. Mason*, 13 Fed. (2nd) 702.

II.

The case involves the construction of Section 31-b of the Revenue Act of 1917, which is as follows:

"Any distribution made to the shareholders or members of a corporation, joint-stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were

paid

accumulated by the corporation, joint-stock company, association, or insurance company, but nothing herein contained shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen."

The judgment of the District Court was entered September 18, 1925 (R. p. 20). The opinion of that Court is fully set out (R. p. 16). The judgment of the Circuit Court of Appeals, reversing the District Court, was filed June 30, 1926 (R. p. 26). The conclusion and determination of that Court are shown in its opinion (R. p. 26). Petition for rehearing was overruled on August 7, 1926 (R. p. 29).

The Circuit Court by its rulings and decision (R. pp. 26, 27, 28) misconstrued and misapplied Section 31-b of the Act of 1917, as hereinafter indicated.

III.

STATEMENT OF THE CASE.

This suit was brought by Mason to recover the sum of $12,458.60 of income taxes wrongfully exacted from him on account of corporate dividends received during the year 1917 from The B. F. Goodrich Company, which were declared and paid as follows:

Stock	Date Declared	Date Paid	Amount Received
Common	October 25, 1916	Feb. 15, 1917	$22,781.00
Preferred	January 24, 1917	Apr. 2, 1917	17,473.75
Common	January 24, 1917	May 15, 1917	22,781.00
Preferred	January 24, 1917	Jul. 2, 1917	17,473.75
		Total—	$80,509.50

These dividends were reported as taxable at the 1916 rates. Subsequently the Commissioner of Internal Revenue determined that such dividends were taxable at the 1917 rates, and thereafter assessed against Mason, and on demand Mason paid to Routzahn as Collector, said additional taxes in the sum of $12,458.60. Mason filed a claim for refund of the amount so paid, which was rejected, and this action was brought to recover the amount of such payment with interest (R. pp. 1, 2, 3, 4).

The answer, while admitting that Routzahn was at all times named in the petition the Collector of Internal Revenue, denied all other allegations of the petition (R. p. 15). The parties waived a jury and the case was tried to the District Judge on an agreed statement of facts (R. pp. 6-15).

It appeared from the agreed facts that up to July 2, 1917, The B. F. Goodrich Company had no undivided profits or surplus for the year 1917 from which dividend distributions could be made. It was therefore claimed by Mason that on any theory of the case the dividends in question received by him from The B. F. Goodrich Company were taxable only at the 1916 rate.

In due time the District Court entered its judgment in favor of Mason for the amount claimed in the petition, with interest thereon, to-wit, the total sum of $14,202.72 (R. p. 20). As shown by the opinion (R. pp. 16-20), the District Judge found and held that in determining from what year's undivided profits or surplus a dividend distribution should be deemed to have been made, the *dividend declaration* constituted the "distribution" to the stockholders within the meaning of Section 31-b of the Act of 1917; that upon the agreed facts The B. F. Goodrich Company had no profits or surplus for the year 1917 before and up to January 24, 1917, the date of the last declaration of dividends, and that the dividend distributions were from

the undivided profits or surplus of the Company existing in the year 1916,—by reason of which, and because of his conclusions of law, judgment was entered for the plaintiff.

The Collector took the case to the Circuit Court of Appeals on writ of error. That Court reversed the judgment of the District Court and remanded the cause with directions to enter judgment for Routzahn (R. p. 26).

In deciding this case the Circuit Court of Appeals misconstrued the decision of this Court in *Edwards v. Douglas*, 269 U. S. 204, and based its decision mainly upon a single paragraph found in the opinion of Mr. Justice Brandeis,—overlooking, we believe, the central ideas and intention of this Court in that decision.

The Circuit Court of Appeals reached the conclusion that the dividend declaration did not constitute a "distribution" within the meaning of the 1917 Act (R. p. 27). The exact statements of the Court are hereinafter quoted on page 19.

The Circuit Court of Appeals also determined that the phrase "most recently accumulated undivided profits or surplus" did not mean those earned *before and up to the time of the dividend distribution*, but meant those finally ascertained and entered as the profits for the entire year (R. p. 28). We quote in full the language of the Court on page 9.

Thereupon the Court reversed the judgment of the District Court and directed judgment to be entered in favor of Routzahn.

IV.

The decision of the Circuit Court of Appeals is erroneous in two important respects, each of which is contrary to principle and to the provisions and meaning of Section 31-b of the Act of 1917:

1. It held that, for the purpose of determining from what year's profits a dividend distribution should be deemed to have been made, the "most recently accumulated undivided profits or surplus," are "those which are *finally ascertained and entered* as the profits for the entire year during which dividends are paid," and are to be "judged from the end of the fiscal year during which the income was received," even though up to the time of the dividend distributions there were no profits for that year.

2. It held that the *dividend declaration* does not constitute a "distribution" by a corporation to its stockholders within the meaning of Section 31-b.

ARGUMENT.

This case involves the construction and application of Section 31-b of the Revenue Act of 1917 relative to two important questions:

1. What are the "most recently accumulated undivided profits or surplus"? Are they "those which are finally ascertained and entered as the profits of the entire year during which dividends are paid," to be "judged from the end of the fiscal year during which the income was received," even though they did not come into existence until after the distribution by the corporation? Or, are they those which were accumulated before and up to the time of the distribution, including current earnings of the corporation before and up to said date?

2. What constitutes the distribution which, by Section 31-b is deemed to have been made from the most recently accumulated profits or surplus? Is it the dividend declaration or is it the dividend payment?

In considering these questions, the purpose of Congress in enacting Section 31-b and adopting its various provisions is of primary importance. The country was faced with war conditions, which required that vast additional sums become available to meet the necessary outlays, and Congress had determined that the income taxes must be very greatly increased. It doubled the normal tax and increased the surtax on graduated scales up to sixty-three per cent., so that incomes in general were to be thenceforward taxed at these greatly increased rates.

But to prevent inequalities and great injustice in the taxation of corporate dividends, Congress determined to make a modification as to taxation of dividends.

We need not elaborate this situation because it is found vividly set out in the decision of this Court in

Edwards vs. Douglas, 269 U. S. 204. The provision for the special modification which Congress determined upon is made in Section 31-b of the Act. The purpose of Congress in adopting the particular provisions of this section are specifically stated in the opinion of Mr. Justice Brandeis in *Edwards vs. Douglas*, pages 216-17:

> "Its general aim was clearly to make the dividend, in whatever year paid, bear the tax rate of the year in which the profits of which it was a distribution had been earned."

The special aim was to make the "war profits pay the high war taxes." To accomplish this purpose it was necessary to provide against postponement of distribution of the most recent earnings, which would pay the highest rate, by declaration of dividends from surpluses of earlier years, as to which there would be low tax rates.

It was essential therefore, that, instead of allowing the directors of corporations to determine and declare what years' surpluses were being distributed, a conclusive presumption should be substituted for the discretion of the directors in this respect. Congress therefore provided that

> "*Any distribution* made to the shareholders • • • shall be deemed to have been made from the *most recently accumulated* undivided profits or surplus."

In the light of the foregoing purposes, we may more readily determine the questions here involved.

POINT I.

AS USED IN SECTION 31-b OF THE 1917 ACT, THE "MOST RECENTLY ACCUMULATED UNDIVIDED PROFITS OR SURPLUS" MEANT THOSE WHICH HAD BEEN EARNED BY THE CORPORATION BEFORE AND UP TO THE DIVIDEND DISTRIBUTION, AND DID NOT INCLUDE THOSE COMING INTO EXISTENCE DURING THE SAME YEAR BUT AFTER THE DISTRIBUTION.

The question here presented is one of law. With reference to a dividend distribution, what are the "most recently accumulated undivided profits or surplus" within the meaning of Section 31-b? The District Court held that the most recently accumulated profits of The B. F. Goodrich Company were those existing before and up to the dividend distribution, namely, the 1916 profits. The record shows and Mason pointed out in the Circuit Court of Appeals that the corporation had no current profits earned for the year 1917, either at the time of the declaration or of the payment of the dividends in question, and therefore claimed that those most recently accumulated by the company were the 1916 profits.

The Circuit Court of Appeals proceeded upon the assumption that the facts were true as claimed by Mason, but disposed of this question adversely to the taxpayer, by determining that the "most recently accumulated undivided profits or surplus" did not mean those most recently earned by the corporation before the dividend distribution, but meant those "*finally ascertained and entered* as the profits for the entire year during which dividends were paid." And since the corporation earned profits during the year 1917 after July 2nd, which appeared on its books at the end of that year, the Court held that these constituted the most recently accumulated profits from which the dividends in question were deemed to have been paid.

In its opinion the Court of Appeals said: (R. p. 28)

"This brings us to the phrase 'most recently accumulated' profits. This may refer to any one of three kinds of profits. *First,* those which at the time of the dividend payment have been formally recognized and entered on the books as profits for a fixed period, and are normally destined to be paid out in dividends; *second,* those which in fact have then come into existence but have not been ascertained or stated on the books; *third,* those which are finally ascertained and entered as the profits for the entire year during which dividends are paid. The first construction must be rejected on the authority of *Edwards vs. Douglas.* The second is logically permissible, but is impracticable. Not only may profits seeming to exist in July disappear before the end of the year, but it is often, if not typically, humanly impossible to determine with any accuracy in what months of the year the profits were made. To attempt to administer the law upon this theory would bring endless and hopeless confusion and disputes. A meaning which would inevitably make the law most difficult of application and in large degree unworkable ought not unnecessarily to be attributed to Congress.

"The *third construction* cannot be spelled out in the very words of the law; but if the entire taxing year should be taken as a unit, as Justice Brandeis says should be done (probably as applied here meaning 1917), it is seen that when the return was made in March, 1918, the taxpayer knew that profits had been accumulated in 1917 from which all 1917 dividends could be paid; and it is not unreasonable to suppose that the 'most recently accumulated profits' are to be judged from the end of the fiscal year during which the income was received. * * * and we conclude that the principle on which *Edwards vs. Douglas* was decided requires us to adopt this third construction."

Based on these holdings the Court decided that all the dividends received by Mason in 1917 should be taxed at

the 1917 rate, notwithstanding the Company had earned no profits for that year up to July 2nd.

This reasoning and decision of the Circuit Court of Appeals are in plain conflict with the holding of this Court in *Edwards vs. Douglas.*

The Court of Appeals says that the phrase "most recently accumulated profits" may refer to any one of three kinds of profits:

> *First.* Those which at the time of the dividend payment have been formally recognized and entered on the books as profits for a fixed period and are normally destined to be paid out in dividends.
>
> *Second.* Those which in fact have then come into existence but have not been ascertained or stated on the books.
>
> *Third.* Those which are finally ascertained and entered as the profits for the entire year during which dividends are paid.

The first construction was rejected on authority of *Edwards vs. Douglas.*

The *second* construction was rejected, on the ground that it was impracticable and unworkable and "ought not unnecessarily to be attributed to Congress." This construction was the one which had been adopted by the Department and for a number of years had been found practicable and workable. It was the construction which was adopted by this Court in *Edwards vs. Douglas;* and, in the outset, the holding of the Circuit Court of Appeals rejecting this construction was in direct conflict with that decision.

It was the claim of Douglas that within the meaning of the law the undivided profits or surplus must be those which had been determined and entered on the books of the Company at the end of the preceding year, although it was conceded that ample current profits had been earned

and were available. It was the claim of the Government that the "most recently accumulated" profits or surplus included current earnings and profits, whether entered on the books or not. The entire litigation centered around this controversy, and this Court held that "most recently accumulated profits" included current earnings, whether or not entered on the books.

On page 214 of the opinion, Mr. Justice Brandeis said:

> "On the other hand, the term 'undivided profits' has not acquired in corporate finance and accounting a like fixed meaning. It is not known as designating generally in business an account on the corporation's books, as distinguished from profits actually earned but not yet distributed. Few business corporations establish an 'undivided profits' account. By most corporations the term 'undivided profits' is employed to describe profits which have neither been distributed as dividends nor carried to surplus account upon the closing of the books; that is, current undistributed earnings.
>
> "That this is the natural meaning of the term 'undivided profits' is indicated by the action of both Douglas and his estate. That this is the meaning in which it was used by Congress is confirmed by the use of the expression 'earnings and profits' later in the same paragraph, and, also, by the use of the term 'undivided profits' in Section 207."

After stating the general aim of Congress in adopting Section 31-b, this Court, on page 216 of its opinion, said:

> "In providing measures for the attainment of that aim, it could be of no practical significance whether, *at the time of the payment of the dividend,* these profits appeared in a surplus or undivided profits account (as the profits earned within part of a year would, where a corporation closed its books monthly, quarterly, or semi-annually) or whether they still rested as current earnings without formal determination or specific allocation."

This language could not be more appropriate as an answer to the reasoning of the Circuit Court of Appeals if it had been now used by this Court for that express purpose.

The second construction should therefore have been adopted.

The *third construction* was adopted by the Circuit Court of Appeals and made the basis of its decision. We believe that this construction cannot be sustained on any theory. It also is in conflict with the principles announced in *Edwards vs. Douglas.*

In advance of stating its reasons for this holding, the Circuit Court of Appeals said that this construction "*cannot be spelled out in the very words of the law.*" An examination of the Section will show that this statement is undoubtedly correct. But it is universally held that a construction of a taxing law which cannot be found or spelled out in the words of the law should not be adopted or applied. *U. S. vs. Merriam,* 263 U. S. 179. Citing *Partington vs. Attorney General,* 4 H. L. 100, 122; *Eidman vs. Martinez,* 184 U. S. 578, 583; *Smietanka vs. Bank,* 257 U. S. 602, 605, 606.

This Court did not suggest a construction which could not be spelled out in the words of the law; and an examination of the opinion in *Edwards vs. Douglas* will show that this *third* construction is contrary to that decision.

If, as held by this Court, the most recently accumulated profits or surplus referred to in Section 31-b were not confined to those which were determined and entered on the books at the close of a year, but included current earnings from the first of the current year up to the dividend distribution,—then certainly, the Circuit Court of Appeals was wrong in holding that the most recently accumulated profits, etc. were those "which are finally ascertained and *entered* as profits for the *entire* year," to be "judged from

the end of the fiscal year during which the income was received."

In *Edwards vs. Douglas* it was undisputed that the profits accumulated for the calendar year 1917 were more than sufficient to pay all dividends distributed during that year.

If, in determining whether dividends were distributed out of the current year's profits, it were only necessary to find those "finally ascertained and *entered* as the profits for the entire year," then the whole analysis and reasoning of this Court in *Edwards vs. Douglas,* with reference to the meaning of "undivided profits," would have been beside the point. This Court would have needed to go no further than to find the conceded fact that the entire year's profits, entered at the end of the year, were more than the year's dividends.

But this Court did not intend any such construction. Throughout the opinion of Mr. Justice Brandeis the words "current earnings" and "current undistributed earnings" are repeatedly found, referring to the current earnings from the first of the year up to the dividend date. For example, on page 208 of the opinion the following appears:

> "It is not suggested that the approximate amount of the undivided current earnings of 1917 accrued and undivided *at the times these dividends were paid* was not in fact known to be sufficient for this purpose."

Also, on page 216, the following appears:

> "In providing measures for the attainment of that aim, it could be of no practical significance whether, *at the time of the payment of the dividend,* these profits appeared in a surplus or undivided profits account * * * or whether they still rested as current earnings without formal determination or specific allocation."

It is true that in *Edwards vs. Douglas* this Court did not in express terms determine the meaning of "most recently accumulated undivided profits" as applied to a cor-

poration which had no earnings for the current year up to the time of the dividend distribution. But the only inference to be drawn from that decision is that "most recently accumulated profits" mean only those earned *before and up to* the time of the distribution. If profits earned *after the distribution* were to be included, the entire discussion as to the use and application of "current earnings" would have been unnecessary.

Notwithstanding the evident conflict between its decision and that of this Court in *Edwards vs. Douglas,* the Circuit Court of Appeals announced that it was following and conforming to that decision. The Court said (R. p. 28):

> "The third construction cannot be spelled out in the very words of the law; but if the entire taxing year should be taken as a unit as Justice Brandeis says should be done, * * * it is seen that when the tax return was made in March, 1918, the tax payer knew what profits had been accumulated in 1917."

and finally the following:

> "We conclude that the principle on which *Edwards vs. Douglas* was decided requires us to adopt this third construction."

The "principle" referred to is found in a single line of the opinion of Mr. Justice Brandeis, which we believe was given a meaning not warranted by its context.

On page 216 of the opinion in *Edwards vs. Douglas,* the following appears:

> "Its general aim was clearly to make the dividend, in whatever year paid, bear the tax rate of the year in which the profits of which it was a distribution had been earned; *and for this purpose to treat as a unit the profits of the whole tax year.*" (Italics ours.)

It was the last clause in this statement which was seized upon by the Circuit Court of Appeals, and treated as giving color to the whole decision.

It will be observed that Mr. Justice Brandeis did not say that the "entire *taxing year* should be treated as a unit," as stated by the Circuit Court of Appeals. What he did say was, "and for that purpose to treat as a unit the *profits* of the whole tax year." There is a plain difference between treating an entire *taxing year* as a unit, and treating as a unit the *profits* of a whole tax year. Furthermore, the purpose referred to by Mr. Justice Brandeis was entirely overlooked. What was the purpose of treating as a unit the profits of a whole tax year? This is shown by the context, both preceding and following, namely: to make the dividend, in whatever year paid, bear the *tax rate* of the year in which the profits entering into it had been earned.

For example, the 1917 tax rate was high. A lower tax rate had been fixed for the year 1916, and still lower for the year 1915. If a corporation had accumulated profits which had been earned in those years respectively, then all of the profits of any one year would be treated as a unit, every part of which, whenever distributed, would bear the tax rate for that year; so that if any part, whether large or small, should be taken out and distributed as a dividend, the amount so distributed would bear the tax rate of that year.

Mr. Justice Brandeis was construing and giving application to the provision:

> "and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation."

The Circuit Court of Appeals used his statement as a construction of the earlier provision:

> "shall be deemed to have been made from the most recently accumulated undivided profits or surplus."

The use of a statement made to explain the determination of a *tax rate*, which would be applicable to the profits of a given year, as a construction of "the most recently

accumulated profits or suplus," must lead to erroneous results.

In addition to all the foregoing, the construction of Section 31-b which was adopted by the Circuit Court of Appeals is contrary to the express terms of that Section; and is contrary to its meaning, as shown by its history. It would also render impossible the uniform application of the law; and is in direct conflict with the regulations, practices and accounting of the Treasury Department from the time when the law of 1917 went into effect.

It is plain that the provision, "shall be deemed to have been *made* from the *most recently accumulated* profits or surplus," when applied to a dividend distribution, speaks in the past tense, as to profits already in existence, and not those to be earned in the future. How could a distribution be "*deemed to have been made*" from profits not in existence?

The expression, "most recently accumulated", refers to profits which have already been earned up to the time of the distribution. No taxpayer could reach the understanding that the law referred to profits not then in existence but which *might* thereafter be earned. That the Department itself construed the law as referring to past profits or surplus, and by its regulations and practices applied it in this way, will be hereinafter shown; and that taxpayers had the right to so construe it is evident from the ordinary meaning of the words used.

The history of Section 31-b during its progress through the Houses and Committees of Congress demonstrates the intention of Congress as to its meaning. In the Senate Bill, as first passed, it was provided that "any distribution made to the shareholders * * * of a corporation * * * shall be deemed to have been made *from the net income of the year in which such distribution is made or, if such income is insufficient,* from the most recently accumulated undivided

profits or surplus" (See Congressional Record, Vol. 55, part 7, pp. 6869-70, 6877-86).

The Conference Committee eliminated the italicized words. Had the Senate Bill passed unchanged, it would have expressed exactly the holding which was made by the Circuit Court of Appeals in this case. Had the omitted provision been retained in the law, however, no one could have determined, at the time of a dividend distribution, from what year's earnings it would be deemed made. Congress therefore eliminated this provision from the bill which was finally passed, thus conclusively demonstrating its intention that dividend distributions should not be deemed to have been made from earnings not then in existence but later accumulated.

Furthermore, the construction adopted by the Circuit Court of Appeals would render nugatory the express provision of Section 31 (b)—

> "But nothing herein contained shall be construed as taxing any earnings or profits accrued prior to March 1, 1913, but such earnings or profits may be distributed as stock dividends or otherwise, exempt from tax, after the distribution of earnings and profits accrued since March 1, 1913, has been made."

This provision contains no limitation as to the time during the year when the distribution may be made exempt from tax, but unless the most recently accumulated undivided profits or surplus for the current year referred only to the current profits up to the date of the distribution, and not to those thereafter earned, the Board of Directors would never be able to determine whether or not they had distributed the earnings and profits accrued since March 1, 1913. Such a result for this provision could not have been intended by Congress.

The construction of Section 31 (b) adopted by the Circuit Court of Appeals would render the uniform application of the law impossible.

If the most recently accumulated profits for a current year were those "finally ascertained and entered as the profits for the entire year during which dividends are paid," neither a taxpayer nor the Department could apply the law to the yearly earnings of a corporation which operated on the basis of a fiscal year not corresponding with the calendar year. In such a case the termination of the fiscal year might be after the time when the tax return was filed, and would include parts of two calendar years. It would then be impossible to determine with any accuracy, and could not be determined at all from the books, as to what rates would be applied in case the rates of the two years were different.

That the decision of the Circuit Court of Appeals adopting this third construction is incorrect and should not be approved, is shown also by the fact that it is in conflict with the regulations, practices and accounting adopted and applied by the Treasury Department from the time when the law of 1917 went into effect until the Circuit Court of Appeals rendered its decision in this case. The understanding of the Treasury Department and the indication of its rulings and dealings with taxpayers are shown by Treasury Regulation No. 33, which provided that:

> "If a corporation distributed dividends in 1917, such dividends will be deemed to have been paid from earnings of 1917, and the recipient, if an individual, will be liable to additional tax if any, and if a corporation, to income tax at the rates for the year 1917, unless it is *shown to the satisfaction of the Commissioner of Internal Revenue that at the time such dividends were paid the earnings up to that time were not sufficient to cover the distribution, in which case the excess over earnings of the taxable year will be deemed to have been paid from the most recently accumulated surplus of prior years,* and will be taxed at the rate or rates for the year or years in which earned."

POINT II.

FOR THE PURPOSE OF DETERMINING FROM WHAT YEAR'S PROFITS OR SURPLUS A DIVIDEND DISTRIBUTION IS DEEMED TO HAVE BEEN MADE, THE DIVIDEND DECLARATION CONSTITUTES THE "DISTRIBUTION" WITHIN THE INTENT AND MEANING OF SECTION 31-b.

By reason of the situation as to the 1917 earnings and profits of The B. F. Goodrich Company, this case could safely be disposed of on the considerations hereinbefore set forth, but in view of the decision of the District Court, which was reversed by the Circuit Court of Appeals, and because the public interest requires a complete construction of this Act, it is important that the second erroneous holding of the Circuit Court of Appeals be considered.

The law does not in terms specify or define what shall constitute the "distribution" which is deemed to have been made from the most recently accumulated profits or surplus.

The District Court in this case determined that the dividend distributions made by The B. F. Goodrich Company, and not the payment constituted the "distribution" (R. pp. 18, 19), and since The B. F. Goodrich Company had earned no profits for 1917 up to that time, determined that the distribution should be deemed to have been made from the 1916 surpluses of the Company (R. pp. 18, 19).

The Circuit Court of Appeals reversed this holding upon the grounds stated in its opinion (R. p. 27):

> "The Court below concluded that the 'distribution' was made when the dividend was declared, segregated from the body of undivided profits, and became a debt from the company to the stockholder which he could sell independently of the stock. *That as between the stockholder and the corporation and from many points*

> *of view such a declaration is a distribution of profits, is indisputable;* but this is a taxing statute, the dominant thought of which is that the citizen should suffer an annual burden upon his annual income. *'Distribution' must mean a disposition which at that moment results in income;* because to ascertain taxable income is the purpose and subject matter of the Act, and a dividend declared this year, payable in the next or some other distant year, is not within the normal conception of income for this year." (Italics ours)

Here we find the assertion that the language of the Act, although it has a well defined and well recognized legal meaning for all ordinary business purposes, is to be given a different and new meaning and interpretation, not ordinarily used or understood, merely because it occurs in a taxing statute. Such a doctrine would generally be deemed unsound. But when the result of it is to impose taxation, it then becomes plainly contrary to the fundamental rules of law for the interpretation of taxing statutes.

The statement of the Court that

> "distribution must mean a disposition which at that moment results in income; because to ascertain income is the purpose and subject matter of the Act,"

likewise disregards the purpose of Section 31-b as announced by this Court. The purpose of that section was to provide for fixing *tax rates* as to dividends, not to ascertain taxable income.

The conclusions of the Circuit Court of Appeals upon the grounds stated by it should not stand unless sustained by other and more persuasive considerations. We submit that a study of the section will indicate that the Circuit Court of Appeals erred in its conclusions.

It is undoubtedly true that the words *"any distribution made* to stockholders" are broad enough to cover and include any kind of distribution or any property distrib-

uted. The intention of Congress therefore, must be determined from the language of the Act, together with the known conditions of its adoption. Certain legal situations, which by implication affected and entered into this Act, were a matter of common knowledge.

Under the state laws generally no dividend could be declared except out of corporate profits or surplus found by the directors to be then in existence and available and sufficient for that purpose.

The courts of New York, under the laws of which The B. F. Goodrich Company was organized, and courts generally, had held that the act of declaring a dividend at once irrevocably created a debt from the corporation to each stockholder,—a property right which could be assigned, transferred or dealt with by the stockholder independently of his stock.

Wheeler vs. Northwestern Sleigh Co., 39 Fed. 347;
Bowers vs. Post, 209 Fed. 660;
U. S. vs. Guinzburg, 278 Fed. 363;
Hopper vs. Sage, 112 N. Y. 553;
Laurie vs. Trust Co., 272 N. Y. 137;
Fletcher, Cyc. of Corporations, Vol. 6, Sec. 3853; L. R. A. 1917 (b) 728 and 736;
U. S. Trust Co. vs. Barker, 33 N. Y. Supp. 388.

Upon the declaration of a dividend the surplus profits of the corporation are at once reduced and the obligations correspondingly increased.

All of this was generally understood and must have been in the mind of Congress.

The declaration of a dividend, therefore, was understood to effect a reduction of the assets of the corporation and to give property rights to the stockholders. The payment was a resulting ministerial incident. Had Congress intended to adopt any rule setting aside or modifying these

fundamental principles of corporate procedure and accounting, it certainly would have indicated that fact in unmistakable terms. Its silence must be taken to show its intention to treat, and authorize taxpayers to treat, the declaration of dividends in the way which had been customarily understood.

It must be conclusively presumed that Congress intended that directors should comply with the law and should only declare dividends out of the existing surpluses and undivided profits; and we cannot fairly assume that such dividend distributions were intended by Congress to be "deemed to have been made" out of profits not then in existence.

Having in mind this legal situation and its results, we may consider the terms and language of Section 31-b.

In view of the general aims of Congress hereinbefore referred to, as found by this Court, it will be kept in mind that Congress meant to prevent directors from determining, in connection with the declaration, as to what year's profits were thereby distributed, and intended to substitute for the discretion of the directors in this respect a conclusive presumption.

Since, in the absence of such presumption, the determination of the board as to what year's profits or surplus were distributed would be a part of the declaration of a dividend, it would follow that the *conclusive presumption* which took the place of the exercise of such discretion, would relate to, and take effect as of, the time of such declaration. Indeed, it would by implication, enter into and be a part of the declaration of every dividend.

It cannot be presumed that Congress contemplated that the declaration of a dividend and the payment thereof would each separately constitute the "distribution." In view of the known legal requirements for and the legal results of a dividend declaration, is it not evident that by

using the comprehensive words, "any distribution," Congress intended to designate and embrace the declaration, which appropriates the corporate profits and creates the corporate obligations to the stockholders? This interpretation would give harmonious meaning and effect to the entire section.

An indication as to the intent of Congress in using the words, "any distribution" is found in the language of this section. It begins with the statement:

> "*Any distribution* made to the shareholders * * * shall be deemed to have been made from the most recently accumulated profits or surplus."

Following this is the statement:

> "and shall constitute a part of the annual income of the distributee *for the year in which received.*"

If the distribution by the corporation here referred to had been intended to be synonymous with receipt of payment by the stockholder, then the second clause was unnecessary; but here two ideas are expressed, both of which refer to dividends declared by corporations.

Thus the declaration of the dividend, as to which the conclusive presumption is a part, is first dealt with; the receipt of payment thereof is dealt with separately. Had Congress intended only to deal with the receipt of payment, and to provide that payment should be deemed to have been made from the most recently accumulated profits, etc., it would have been easy to express such intention in plain language, but this would have changed the sense of important parts of this section.

If we should substitute the words "dividends paid" for "distribution made," Section 31-b would read as follows:

> "Any dividends paid to the shareholders, * * * of a corporation * * * in the year 1917, or subsequent tax years, shall be deemed to have been paid from the

> most recently accumulated undivided profits or surplus, and *shall constitute a part of the annual income of the distributee for the year in which received,* and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, etc."

The italicized portion of the above clause is surplusage, because Section 1200 of the Act defines income to include gains, profits and income derived from dividends, and Sections 1 and 2 of the Act tax income *received* in the calendar year 1917, and every calendar year thereafter.

Substituting "dividends declared" in place of "distribution made", the section would read:

> "Any dividends declared to the shareholders of a corporation in the year 1917, or subsequent tax years, shall be deemed to have been declared from the most recently accumulated undivided profits or surplus and *shall constitute a part of the annual income of the distributee for the year in which received,* and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation."

In the foregoing, the italicized portion is essential to the meaning of the section, and, if omitted, would change Sections 1 and 2 so as to require taxpayers to pay the tax on *dividends declared* as distinguished from dividends received.

In addition to the foregoing, Section 31-b contains a further demonstration that Congress intended "any distribution" to embrace the *declaration* of the dividend.

It will be observed that the words "any distribution made" are used in the first line of the section. The same words are used in the same way and in the same sense in the last clause of the section.

If the words, "this sub-division shall not apply to *any distribution made* prior to August 6, 1917," were in-

tended by Congress to embrace the declaration of dividends, then it undoubtedly follows that the same words used in the first line of the section must likewise include the declaration of dividends. These words were not used in identical form in two places by accident.

The meaning of "any distribution made" in the last clause is evident from the history of its enactment.

The proposed law was at first reported and given publicity without the last proviso. This was done on August 6, 1917. A great many corporations had acted in reliance upon the law as it then existed, under which dividends might be declared, free from tax, out of undivided profits and surplus earned prior to March 1, 1913. Many of such dividend declarations had been made even after August 1, 1917.

Upon the publication of the proposed act, protests were sent in from every direction. This is publicly known, and is shown and discussed in *Montgomery on Income Tax Procedure* (1918 Edition) page 153. Thereupon the Conference Committee, in order to prevent the grave injustice which would have resulted, had the law been enacted as first published, determined upon and reported the last proviso as a part of Section 31-b.

We should not impute to the Committee and to Congress the intention by this proviso to relieve stockholders who had received payment of such dividends before August 6, 1917, but to tax stockholders where such dividends had been declared, and the debts created, before that date, but actual payment had not been made.

Directors had acted in reliance upon the existing law, which permitted dividends to be declared and paid out of earnings prior to March 1, 1913 without tax. Such declaration of dividends appropriated the 1913 surplus and created indebtedness from the corporation to its stockholders which could not be revoked, and must be paid.

In granting the relief intended by the last proviso, it is not conceivable that Congress proposed to relieve a part of the stockholders who would have been innocently entrapped, but to withhold relief from the others who were in practical effect identically situated.

Within the intention of Congress, therefore, the words, "any distribution made," found in the proviso, must have embraced *the declaration* of the dividend. It follows that the same words found in the first line of this section were intended to have the same meaning.

The conclusion that the "distribution" by a corporation to its stockholders must be deemed to have been made from those profits which were, at the time of the dividend declaration, the most recently accumulated undivided profits or surplus, is sustained by the decisions of numerous courts and of the Board of Tax Appeals.

U. S. vs. Guinzburg, 278 Fed. 363; (C. C. A., 2nd Circuit);
Plant vs. Walsh, 280 Fed. 722;
Phillips vs. U. S., 12 Fed. (2nd) 598;
Appeal of A. H. Stange, 1 B. T. A. 810;
Appeal of Harmon W. Hendricks, 4 B. T. A. [illegible] C. C. H. 1926 B. T. A. Service, Vol. 3, p. 3259;
Appeal of Mary A. Fitzgerald, 5 B. T. A. 178, C. C. H. 1926 B. T. A. Service, Vol. 3, p. 3389;
Appeal of Maurice J. Curran, 5 B. T. A. 180, C. C. H. 1926 B. T. A. Service, Vol. 3, p. 3399.

In *U. S. vs. Guinzburg*, a corporation had declared a dividend on February 17, 1913, payable July 1, 1913. The Department claimed that when the dividend was paid it constituted taxable income of Guinzburg for the year 1913. The Circuit Court of Appeals held that the amount of this dividend was capital of the stockholder at the time the Act of 1913 took effect and not taxable income arising or accruing thereafter.

On pages 363 and 364 of the opinion the court said:

"We think the dividend declared prior to March 1, 1913, the effective date of the income tax here considered, was not income when paid because it was part of the capital of the defendant in error on March 1, 1913. By the declaration of a dividend, the earnings of the company, to the extent declared, were separated from the property of the corporation, and were appropriated by that action to the then stockholders, who became creditors of the corporation for the amount of the dividend. The relation then created was that of debtor and creditor (citing many authorities). It is the separation of the earnings from the balance of the corporate property, together with the promise to pay, arising from the declaration of the dividend, that works this change. The holder of the stock with respect to the dividend is on a par with other creditors of the corporation. *Staats v. Biograph Co.*, 236 Fed. 454. The fact that the dividend is payable at a future date does not alter the rights thus created. The obligation of the corporation as debtor commences with the declaration of the dividend although the payment is postponed for the convenience of the company. The rights of the stockholders are immediately vested the moment the dividend is declared. The action of the Board of Directors is the appropriation of a portion of the earnings to the defendant in error as the holder of a certificate of stock. The same rule prevails in the state courts of New York under which laws the corporation here in question was organized."

On page 366 the court said:

"We conclude that, upon the declaration of a dividend the debt was immediately created in favor of the defendant in error, payable at a future date. By that action, a vested right was created in favor of the stockholder, who could sell his right by assigning or pledging or otherwise disposing of it, and this was not income arising and accruing within the meaning of the statute such as might be taxed under the income tax act of March 1, 1913, here in question."

In *Appeal of A. H. Stange* (decided March 18, 1925) the Board of Tax Appeals construed sub-section (b) of Section 31 of the Revenue Act of 1917.

In that case the Directors, on January 27, 1917, declared a dividend of $125,000 "to be paid to the stockholders when and as directed by the officers or directors." This dividend was actually paid to the stockholders as follows:

August	8, 1917	$14,000.00
September	5, 1917	21,000.00
November	20, 1918	49,000.00
January	13, 1919	41,000.00

For each of the years from 1913 to 1916 inclusive, the corporation sustained losses. For each of the years 1917 to 1919 inclusive, the corporation had earnings and profits sufficient to pay the amounts of dividends actually paid in those years. The Commissioner proposed to tax the amounts actually paid in each of the years as dividends in those years.

The Board of Tax Appeals held that these dividends were distributed out of surplus accumulated prior to March 1, 1913, and therefore were not taxable.

On page 813 the Board stated in its opinion:

> "From the above authorities we are of opinion that the resolution of the Board of Directors of A. H. Stange Co. of January 27th constituted a valid declaration of a dividend at that time, even though payment was to be made when and as directed by the officers or directors.
>
> "The determination of the principal question herein depends, in the last analysis, upon the construction which must be given to the words, 'any distribution made,' as used in Section 31-b of the Revenue Act of 1917. If these words have reference to the declaration of a dividend, the taxpayer must prevail; if they mean the actual time of payment of the dividend, then it will

be necessary to construe the limitation upon distribution of the earnings and profits in said section. It is therefore necessary to ascertain the legal effect of a resolution declaring a dividend. The definition of a dividend in Section 31-a of the 1917 Act as 'any distribution made or ordered to be made by a corporation * * * out of its earnings or profits * * * and payable to its shareholders' comports with the general definition of a dividend, and for the purposes of this case may be taken as correctly defining a dividend declared out of earnings or profits accrued prior to March 1, 1913. What then is the legal effect of the declaration of a dividend? We think the answer to this question is clearly set forth by the court in *U. S. v. Guinzburg,* 278 Fed. 363, wherein the court said (here follows a long quotation from the opinion in the *Guinzburg* case).

"The outstanding features of a dividend declaration are that, by the mere declaration, the dividend becomes thereby separated and segregated from the stock and exists independently of it; the right thereto becomes immediately fixed and absolute in the stockholders, and the corporation becomes a debtor to its stockholders for their pro rata shares. There is an apportionment or division of the assets of the corporation, to the extent of the dividend, to its stockholders. The corporation is at once poorer in the amount of the dividend declaration, and the stockholder becomes richer in his own right, to the extent of his pro rata share. What theretofore existed as undivided profits or surplus has become divided profits and the surplus is reduced to the extent of the dividend declared. It has ceased to be the property of the corporation and has become the property of the stockholder, and his interest therein becomes adverse to the corporation and to every other stockholder. We think this division or segregation of the amount of the dividend from the general mass of the corporate property and its apportionment to the stockholders is included in the words any distribution made, as used in the statute, and that those words must be given the same legal ef-

fect as results from the declaration of a dividend. It follows that the resolution of the board of directors of A. H. Stange Co., passed on January 27, 1917, constitute a distribution to its stockholders at that time of the surplus existing at March 1, 1913, and the fact that payment was made in subsequent years becomes immaterial.

"It remains to apply the provisions of section 31 (b) of the 1916 Act. By that section any distribution made in the year 1917 or subsequent tax years is deemed to have been made from the most recently accumulated undivided profits or surplus, and the presumption thus raised has been held to be a conclusive presumption. *Harder v. Irwin*, 285 Fed. 402; *Douglas v. Edwards*, 298 Fed. 229. The facts herein show that A. H. Stange Co. had operated at a loss in all the years from 1912 to 1917, and there were no undivided profits since 1913 out of which a distribution could have been made, and this appeal could be sustained on that ground. We prefer, however, to rest our decision upon the last sentence of section 31 (b), providing:

"This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen.

"Holding, as we do, that the words any distribution made, as used in the statute, include the declaration of a dividend and must have the same legal effect; and the dividend in question having been declared prior to August 6, 1917, to-wit, on January 27, 1917, the presumption that the distribution was from the most recently accumulated undivided profits or surplus has no application to the facts in this appeal. We are of opinion that the distribution made by the A. H. Stange Co. to its stockholders on January 27, 1917, out of a surplus existing prior to March 1, 1913, is exempt from taxation to the taxpayer herein at the time of the actual payment, and the determination of the Commissioner proposing to tax the same in the years in which it was paid must be disapproved."

In *Appeal of Hendricks, Appeal of Fitzgerald* and *Appeal of Curran, supra,* (decided in September and October, 1926), the Board of Tax Appeals referred to and followed its holding in *Appeal of A. H. Stange.*

CONCLUSION.

The B. F. Goodrich Company had no undivided profits for the year 1917, either at the time of the declaration or at the time of payment of the dividends in question. We believe that the most recently accumulated profits or surplus are those earned before and not after the distribution. In this case those were the profits of 1916. We further believe that in determining the profits distributed, "any distribution made" refers to the declaration of the dividend.

It follows that the District Court was correct in entering judgment in favor of Mason and that the decision of the Circuit Court of Appeals should be reversed.

Respectfully submitted,

S. M. JETT,

HORACE ANDREWS,

Attorneys for Plaintiff in Error.

CHARLES E. HUGHES,

HARRISON TWEED,

Of Counsel.